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IN THE

# SUPREME COURT OF THE UNITED STATES

October Term 1946

No. 1067

JOHN C. CLEAVER,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MALCOLM K. WHYTE
HERBERT C. HIRSCHBOECK
*Counsel for Petitioner.*

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### SUMMARY OF ARGUMENT


1. The courts below revised the contracts from notes with interest paid in advance to notes with interest payable at maturity and disregarded the universal law, custom and understanding of bank discount loans by a construction and application of the words "interest paid" in *Sec. 23(b) of the Internal Revenue Code* not supported by any decision of the Supreme Court. The proper application of that statute to common bank discount loans is an important question of federal law which ought to be settled ..... 7

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

---

**To the Honorable The Supreme Court of the United States.**

Your petitioner, JOHN C. CLEAVER, respectfully shows:

## I.

### Summary Statement of Matter Involved

This is a proceeding for redetermination of an income tax deficiency of $3,060.53 for 1941 decided against petitioner by the Tax Court (R. p. 24; 6 T.C. 452) and the Circuit Court of Appeals for the Seventh Circuit (R. p. 48; 158 F. 2nd 342).

Petitioner filed income tax returns on the cash receipts and disbursements basis and in his return for 1941 deducted $7,756.88 for interest paid in December 1941. This was the interest on three notes to Marine National Exchange Bank of Milwaukee made in December 1941 in the aggregate sum of $68,950, payable "five years after date" and "with interest payable in advance at the rate of 2-1/4 per cent per annum from date to maturity" (Exh. 2, R. p. 37). The notes were secured by assigned policies of insurance on petitioner's life. In making the loans in December 1941 the bank followed the universal custom of bank discount. It computed the interest for the five years at 2-1/4% of the principal per year "and deducted the interest so calculated from the principal amount of each note, making available to petitioner the balance as follows:

| *"Amount of Loan* | *Interest Deducted* | *Net Loan Proceeds* |
|---|---|---|
| $23,400 | $2,632.50 | $20,767.50 |
| 23,400 | 2,632.50 | 20,767.50 |
| 22,150 | 2,491.88 | 19,658.12 |
| $68,950 | $7,756.88 | $61,193.12" |

(Tax Court Finding of Fact R. p. 25)

Respondent and the courts below determined that, regardless of the fact that between petitioner and the bank this interest was paid in December, 1941, petitioner could not deduct the same in 1941 under *Sec. 23(b) of the Internal Revenue Code,* which so far as material is as follows:

"Sec. 23 DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions: * * *

"(b) INTEREST—All interest paid or accrued within the taxable year on indebtedness" * * *

In *I.T. 3740, CB 1945 p. 109,* it had been held: "that where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disburse-

ments basis, interest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes for the year in which paid." The only issue in the courts below was whether the interest had been "paid" in December 1941 as contemplated by *§23(b) of the Internal Revenue Code.*

## II.

## Basis for Jurisdiction to Review

The judgment of the Circuit Court of Appeals for the Seventh Circuit to be reviewed was entered December 3, 1946 (R. p. 52). It is a judgment of a circuit court of appeals on a petition to review a decision of the Tax Court of the United States. Sec. 240 of the Judicial Code as amended, *28 U.S.C. §347,* is believed to sustain the jurisdiction of the Supreme Court to review the judgment on writ of certiorari.

## III.

## Question Presented

The question involved is:

Is bank discount to be recognized as interest paid in advance under *I.R.C. §23(b)* as it is in universal law and business practice or are the words "interest paid" in that section restricted to payment from sources other than the proceeds of the bank discount loan?

## IV.

## Reasons Relied on For Allowance of Writ

a) *The courts below have decided an important question of federal law which has not been, but should be, settled by the Supreme Court.*

The courts below erroneously assumed that the contracts between petitioner and the bank should be reconstructed for

federal income tax purposes to regard them, not as five year notes for $68,950 with interest at 2-1/4% per annum ($7,756.88) paid in advance, but as five year notes for $61,193.12 with interest at 2.535% per annum ($7,756.88) payable at maturity.

No decision of the Supreme Court has so interpreted *Sec. 23(b)* of the *Internal Revenue Code.*

b) *The courts below have decided a federal question in a way conflicting with or misapplying a decision of the Supreme Court.*

*Eckert* v. *Burnet,* 283 U.S. 140, was cited by the Tax Court and by the Circuit Court of Appeals. It was also the basis for the other authorities cited. But the issue in *Eckert* v. *Burnet* was not whether an expense item had been "paid" to be deductible under *Sec. 23(a)* or *(b)* of the *Internal Revenue Code,* but whether the taxpayer "sustained a loss" or had a debt become worthless in the year, deductible under provisions now appearing in *Sec. 23(e) and (k)* of the *Internal Revenue Code.*

c) *The decision of Circuit Court of Appeals for the Seventh Circuit is in conflict with a decision of the Circuit Court of Appeals for the Sixth Circuit on the question whether giving a note for an interest obligation constitutes payment of the interest.*

In *Musselman Hub-Brake Co.* v. *Commissioner of Internal Revenue* (CCA 6th Cir. 1943), 139 F. 2nd 65, the Circuit Court of Appeals for the Sixth Circuit held that the giving of a note for interest and other expenses constituted payment thereof under *Sec. 24(c) of the Internal Revenue Code* which disallows deduction of interest and certain other expenses if not "paid" within a stated time.

This is in conflict with the holding of the Circuit Court of Appeals for the Seventh Circuit in this case that giving

a note in discharge of an interest obligation does not "pay" the interest for federal income tax purposes.

## V.

## Prayer For Writ of Certiorari

WHEREFORE, your petitioner prays that a writ of certiorari issue under the seal of the Supreme Court directed to the Circuit Court of Appeals for the Seventh Circuit commanding that court to certify and send to the Supreme Court a full and complete transcript of the record and of the proceedings of the said Circuit Court of Appeals for the Seventh Circuit in the case numbered and entered on its docket, No. 9132, *John C. Cleaver, Petitioner vs. Commissioner of Internal Revenue, Respondent,* to the end that it may be reviewed and determined by the Supreme Court as prescribed by the statutes of the United States; and that the judgment entered therein on the 3rd day of December 1946 be reversed and that petitioner have such further relief which may be proper.

Dated, Milwaukee, Wis., February 20, 1947.

JOHN C. CLEAVER
*Petitioner*

By

MALCOLM K. WHYTE

HERBERT C. HIRSCHBOECK
*Counsel for Petitioner.*

# BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

## I.

## Opinions of Courts Below

The opinion in the Tax Court (R. p. 24) is reported in 6 T.C. 452.

The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. p. 48) is reported in 158 F. 2nd 342.

## II.

## Jurisdiction

1. The date of the judgment to be reviewed is December 3, 1946. The mandate was issued December 30, 1946.

2. The statutory provision which is believed to sustain the jurisdiction of the Supreme Court is *28 U.S.C.* §347 (§240 of Judicial Code as amended). The judgment to be reviewed is the judgment of a circuit court of appeals on a petition to review a decision of the Tax Court of the United States.

## III.

## Statement of the Case

The case has been stated in the "Summary Statement of Matter Involved" in the petition (ante p. 1) and that statement is adopted and made a part of this brief.

## IV.

## Specification of Errors

1. The courts below erred in reconstructing the contracts between petitioner and the bank and in disregarding universal law, banking custom, and the common knowledge of even children in the schools, all of which establish that interest

is "paid" at the making of the loan in the common bank discount loan.

2. The courts below erred in applying *Eckert* v. *Burnet*, 283 U.S. 140, which considered deduction of "loss sustained," to this case, which involves only whether interest was "paid."

## V.

## Argument

### 1.

*The courts below revised the contracts from notes with interest paid in advance to notes with interest payable at maturity and disregarded the universal law, custom and understanding of bank discount loans by a construction and application of the words "interest paid" in Sec. 23(b) of the International Revenue Code not supported by any decision of the Supreme Court. The proper application of that statute to common bank discount loans is an important question of federal law which ought to be settled.*

Petitioner's notes given to the bank in December 1941 were five year notes for $68,950 with interest at 2-1/4% per annum paid in advance. This interest was $7,756.88. The Tax Court found that the bank "deducted the interest so calculated from the principal amount of each note, making available to petitioner the balance" viz. $61,193.12 (R. p. 25).

The courts below concluded, however, that petitioner would not pay the $7,756.88 until maturity of the notes. Such conclusion is consistent only with a revision of the notes to be five year notes for $61,193.12 with interest ($7,756.88) at 2.535% per annum payable at maturity.

This assumption contradicts not only the contracts of the parties, but is contrary to ordinary business of bank discount loans recognized historically, legally, in general banking practice and even in the teaching to the children in the schools.

The Bank of England has been discounting notes since 1694. *History of the Bank of England, Francis* (Euclid Co., 1888) pp. 204-205.

The taking of interest in advance is expressly permitted to national banks *12 U.S.C.* §85 and to state banks in Wisconsin, *Sec. 221.35 Wis. Stats.* (1945). In *Fleckner v. Bank,* 8 Wheat. 338, 354, Mr. Justice Storey said:

> "• • • for the practice is believed to be universal; and probably few, if any, charters contain an express provision authorizing, in terms, the deduction of the interest in advance upon making loans or discounts. It has always been supposed that an authority to discount, or make discounts, did, from the very force of the terms, necessarily include an authority to take the interest in advance. And this is not only the settled opinion among professional and commercial men, but stands approved by the soundest principles of legal construction. Indeed, we do not know in what other sense the word discount is to be interpreted."

The banker testified before the Tax Court that the practice of banks to collect interest in advance had been in the banking system to his knowledge as long as the past forty-six years (R. p. 19). He testified that the interest in this case had been collected in advance by the bank. (R. p. 20.)

A teacher of arithmetic in the Milwaukee Vocational School of twenty-five years experience referred to more than sixteen school-books before the Tax Court. A sample of what they taught is: *Mathematics for the Accountant, Specthrie* (Ronald Press 1940) at p. 30:

> "18. Bank Discount—Bank discount is ordinary simple interest *paid in advance.* Ordinarily it is deducted from the amount of the loan, the borrower receiving the balance."

The teacher testified: "The interest is taught as having been paid at the time the loan is made, not at the time the note becomes due." (R. p. 22); and on cross examination (R. p. 23):

"Q.* * * As a matter of fact, there is nothing actually paid until the note is paid, is there?

"A. The interest is paid.

"Q. Actually paid. I am asking you if it is a fact there is no interest, nothing paid, until the note is paid?

"A. No, that is not true. Interest is paid at the time the loan is made, or the note is discounted."

There was no testimony to the contrary.

Congress said:

> [Internal Revenue Code] "Sec. 23. DEDUCTION FROM GROSS INCOME.
>
> "In computing net income there shall be allowed as deductions: * * *
>
> (b) INTEREST—All interest paid or accrued within the taxable year on indebtedness" * * *.

Of the meaning of "interest on indebtedness" in this section the Supreme Court has said in *Deputy* v. *Du Pont,* 308 U.S. 488, 498:

> "We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In the absence of clear evidence to the contrary, we assume that Congress has used these words in that sense. In sum, we cannot sacrifice the 'plain, obvious and rational meaning' of the statute even for 'the exigency of a hard case.' "

The word "payment" is likewise not of technical legal meaning. It has come into the law from commercial life. *40 Am. Juris. 715, Payment, Sec. 2.*

It is of utmost importance that the Supreme Court settle the question whether the word "paid" in *Sec. 23(b) of the Internal Revenue Code* has the meaning in bank discount loans commonly understood by the people or a meaning implicit in the opinions of the courts below that the borrower

must make his payment from funds other than the loan proceeds or be regarded as having made notes promising payment of interest at maturity.

The Circuit Court of Appeals' decision begs the entire question. The testimony showed that in banking and mercantile practice a borrowing of $1,000 from a bank on a discounted basis where the borrower receives a net of say $950.00 in cash is regarded as a payment of $1,000 by the bank to the borrower and that the borrower from the $1,000 of loan money so received has immediately and simultaneously paid the bank the interest of $50.00. (R. p. 17) The courts below persist in treating it otherwise, namely, that the borrower has given his note to pay the $50.00 at the maturity date rather than actually having paid it in advance from the borrowed money at the time of the transaction. The testimony as to the mercantile and banking practice is uncontradicted and that universal practice and understanding is recognized by the Circuit Court of Appeals. (R. p. 49)

We then get to the question as to whether the Commissioner and Tax Court have the right to convert a transaction which has been regarded in one definite way in mercantile and banking practice for hundreds of years, and was so recognized at the time of the original enactment of Sec. 23(b) of the Internal Revenue Code, into another type of transaction solely for the purpose of denying a deduction.

It is obvious that the authorities cited in its opinion by the Circuit Court of Appeals authorizing the Commissioner to disregard state rules of property, have no bearing. 158 F. 2nd 342, 343. (R. p. 49). The Supreme Court has never yet held that the Commissioner may disregard a universally established mercantile practice in order to create increased tax where otherwise none is due. If it is to be established law that the Commissioner may, in order to secure increased taxes, convert a mercantile practice from what it has always

been considered to be, and from what the parties to the transaction have regarded it, and from what the express language of the instruments provide, then such change in the law should not be made by the Commissioner by asserting deficiencies against isolated taxpayers nor should it be made by lower courts, but a change of such far-reaching consequence should be effected by a clear-cut decision of this Court or by the Congress placing all taxpayers on notice that interest which has been paid in advance will not be deductible at the time of payment but only when the principal is paid.

2.

*The courts below misapplied Eckert v. Burnet, 283 U.S. 140, a "loss" deduction case, to the issue here, which is whether the interest was "paid."*

After having erroneously concluded that the notes promised payment of the interest at maturity, the courts below regarded the issue to be whether giving a note for an obligation constitutes payment thereof.

*Eckert* v. *Burnet*, 283 U.S. 140, and other cases referring to it as authority were cited. (R. p. 50, 26) *Eckert* v. *Burnet* concerned the time of deducting "losses" or "bad debts." The taxpayer was secondarily liable for a debt of a corporation and in the year in question gave his individual note on which he was primarily liable to the creditor bank. The taxpayer claimed indemnity from the debtor corporation was uncollectible and took a deduction in his income tax return for a "loss" or "bad debt" under §*214 (a) (4) and (7)* of the *Revenue Act of 1924* (Now §§*23(e) and (k) of the Internal Revenue Code*). These subsections allowed as deductions: "(4) Losses sustained during the taxable year and not compensated by insurance or otherwise, if incurred in trade or business; * * * (7) Debts ascertained to be worthless and charged off within the taxable year." The question involved in these

cases is apparent from the Circuit Court of Appeals opinion in *Eckert* v. *Commissioner of Internal Revenue,* 42 F. 2nd 158, 159:

> * * * "petitioner did not lose by reason of his indorsement or assumption of a corporation's obligation to the bank by issuing his own note. His liability on the corporation's note arose by reason of the indorsement, and, when he sustains a loss, it must be attributable to that alone. That loss will be realized and may be recognized when payment of the note or part thereof is made in cash."

Whether there is a "loss sustained" in a certain year is essentially a different question from whether an obligation has been "paid."

*Sec. 23(b) of the Internal Revenue Code* allows the deduction of interest when it is "paid." A taxpayer on the cash basis may have liability accruing for interest. At the end of the year he may owe a sum of interest which would reduce his net worth in a statement of his assets and liabilities. Congress has, however, designated the act of "payment" as the occasion for deduction for income tax purposes. If payment is made December 31 the deduction may be made in that year. If it is made January 2 of the next year the deduction must be taken in the next year. The condition for deduction is "payment." It is neither reduction of net worth, nor sustaining loss, nor the incurring of the liability, nor anything except "payment." Nor has the source of the means of payment ever been regarded as significant. Payment with borrowed money is as much payment as with money from any other source. *Keenan* v. *Commissioner,* 20 B.T.A. 498; and other cases cited in *Crain* v. *Commissioner,* (CCA-8) 75 F. 2nd 962.

*Eckert* v. *Burnet,* 283 U.S. 140, has been misapplied in some of the other cases cited by the courts below. Most of them are renewal note cases raising the question whether a renewal note actually discharges the original debt. Some in-

volve accounting between life insurance companies and their policy holders where the concept of a mutual running account prevails. The Tax Court and respondent have, however, in at least one case, not cited by the courts below, recognized the distinction between interest paid in advance in an original discount borrowing, which is deductible, and giving a renewal note for interest indebtedness, which is not. *Arthur R. Wendell* (B.T.A. Mem. Dec. Doc. No. 103,842; (P.H.) T.C. Memo Service §41,561, C.C.H. Dec. 12,225-G).

The misapplication of *Eckert* v. *Burnet*, 283 U.S. 140, ought to be corrected by the Supreme Court.

**8.**

***Other late decisions allow the deduction of interest in essentially the same kind of transactions and the conflict with them and with the holding of the Circuit Court of Appeals for the Sixth Circuit should be settled by the Supreme Court.***

Three citizens entitled to equal treatment under the law, had similar business in 1941. They were Joseph Konigsberg, John C. Cleaver and Newton A. Burgess.

*Joseph Konigsberg* (T.C. Mem. Dec., Doc. No. 4,887; decided Jan. 22, 1946; (P.H.) T.C. Memo Service §46,024, C.C.H. Dec. 14,969 (M)) borrowed $36,000 from the Guaranty Trust Co. and gave his note for five years with interest at 2-1/2% per annum payable in advance. The interest amounted to $4,500 and Mr. Konigsberg gave the Trust Co. his check on another bank for $7,903.80 to cover the interest of $4,500 and another item and received credit for the full loan proceeds of $36,000.

*John C. Cleaver* (petitioner here) borrowed $68,950 from the Marine National Exchange Bank of Milwaukee on notes for five years with interest at 2-1/4% per annum payable in advance. The interest amounted to $7,756.88 and he arranged

to have the bank deduct this sum from the loan proceeds and give him the balance of $61,193.12.

*Newton A. Burgess* (8 T.C.—No. 5 decided Jan. 17, 1947, C.C.H. Dec. 15,550) owed Archer & Co. $203,988.90 due Dec. 30, 1941. For renewal of this obligation he was billed $4,136.46 interest at 2% per annum in advance for one year. On Dec. 20, 1941 he borrowed $4,000 from Archer & Co. on another one year note and mingled the loan proceeds in a checking account in another bank and on Dec. 26, 1941 gave his check to Archer & Co. for $4,219.33 ($4,136.44 plus $82.89 on the $4,000 loan).

The Tax Court held that Mr. Konigsberg and Mr. Burgess had paid interest of $4,500 and $4,219.33 respectively in 1941 and were entitled to deduction thereof on the cash basis in that year under §*23(b) of the Internal Revenue Code.* Mr. Cleaver was denied the deduction.

The cases are identical in substance. When Mr. Konigsberg gave his check for interest of $4,500 on another bank in order to receive credit for the full $36,000 of loan proceeds he was in a position to take $4,500 of the loan proceeds and deposit it in his checking account to offset his interest check. The common bank discount practice would be to net the transaction in the lending bank by deducting the interest from the loan proceeds as in the case of Mr. Cleaver's loans.

The Burgess case involved a renewal note. By the device of a separate $4,000 loan a few days before the renewal and advance interest payment date Mr. Burgess was not any poorer in his net cash position than if he had added $4,000 of interest to the principal sum of the renewal note.

Mr. Cleaver alone proceeded directly according to usual and customary bank discount practice. The others, by unnecessary check or anticipatory separate loan, took steps having no real business purpose.

Since when does federal income tax law exalt form over substance of transactions?

Since when is a taxpayer's transaction without business purpose efficacious to grant him a deduction?

The confusion of the Tax Court cries out for settlement by authoritative decision of the Supreme Court.

"Payment" is made by the agreed "transfer of debits or credits or the application of deposits or funds of the debtor in the hands of the creditor or by the application of mutual indebtedness of the parties." *48 C.J. 626, Payment, Sec. 61, 9.*

This is not a mere rule of state law as the Circuit Court of Appeals said. It is common law and common sense and common business practiced for centuries and even taught to the children in the schools.

The full loan proceeds of $68,950 were Mr. Cleaver's when he signed the notes. From this fund or credit which was his he and the banker agreed that the interest of $7,756.88 should be paid. The bank "deducted the interest so calculated from the principal amount * * * making available to petitioner the balance of $61,193.12." (Finding of Tax Court R. p. 25.)

There would be no business purpose to writing a check on another bank or to making a separate loan from the lender or anyone else for the interest. Is petitioner to be discriminated against because he proceeded simply, directly, without device, in the usual manner of transacting the business?

The conflict in the Tax Court alone should entitle petitioner to review, but a conflict also exists between the Circuit Courts of Appeals for the Sixth and Seventh Circuit. The Sixth Circuit Court has held that giving a note for interest and other expenses constitutes payment under *Sec. 24(c) of the Internal Revenue Code,* a section using the word "paid" necessarily in the same sense in which it is used in *Sec. 23(b).*

*Musselman Hub-Brake Co.* v. *Commissioner,* 139 F. 2nd 65, and *Celina Manufacturing Co.* v. *Commissioner,* 142 F. 2nd 449.

## Conclusion

It is therefore respectfully submitted that this case is one calling for the exercise by the Supreme Court of its supervisory powers by granting a writ of certiorari and thereafter reviewing and reversing the decision of the courts below.

MALCOLM K. WHYTE

HERBERT C. HIRSCHBOECK
*Counsel for Petitioner.*

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OCTOBER TERM, 1946

JOHN C. CLEAVER, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

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# In the Supreme Court of the United States

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No. 1067

JOHN C. CLEAVER, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 24–27) is reported at 6 T. C. 452. The opinion of the Circuit Court of Appeals (R. 48–51) is reported at 158 F. 2d 342.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 3, 1946. (R. 52.) The petition for certiorari was filed February 27, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Whether the petitioner paid "interest" within Section 23 (b) of the Internal Revenue Code and may take a deduction therefor when, at the time he secured three bank loans, he gave the bank notes for an amount including interest as well as the sum actually credited for his use by the bank, and the latter treated the interest as paid in advance.

### STATUTE INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
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> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.
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> * * * * *
>
> (26 U. S. C. 1940 ed., Sec. 23.)
>
> SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.
>
> The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or

incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1940 ed., Sec. 43.)

## STATEMENT

The facts as found by the Tax Court (R. 25) are as follows:

In 1941, the petitioner used his personal account with the Cleaver-Brooks Company of Milwaukee, Wisconsin, to purchase three policies of single premium life insurance and repaid that company by borrowing money from the Marine National Exchange Bank of Milwaukee. In connection with these loans, the petitioner gave the bank three notes, each due five years after date and each expressly providing that interest should be paid in advance at the rate of two and one-fourth per-cent per annum. (R. 25.)

The bank computed interest for five years at two and one-fourth percent on the principal amount of each note and deducted the interest so calculated from the principal amount of each note, making available to petitioner the balance as follows (R. 25):

| *Amount of loan* | *Interest deducted* | *Net loan proceeds* |
|---|---|---|
| $23,400 | $2,632.50 | $20,767.50 |
| 23,400 | 2,632.50 | 20,767.50 |
| 22,150 | 2,491.88 | 19,658.12 |
| 68,950 | 7,756.88 | 61,193.12 |

The bank credited the sum of $7,756.88 to reserve account known as "interest or discount collected in advance," and it then each day took therefrom the amount of interest earned and credited it to its earning account. (R. 25.)

The petitioner reported his income for federal tax purposes on the cash basis. (R. 25.)

The Tax Court held that no interest was deductible by the taxpayer in 1941 and decided that there was a deficiency in income tax in the amount of $3,060.53. (R. 27.) This decision was affirmed by the Circuit Court of Appeals for the Seventh Circuit. (R. 48–52.)

## ARGUMENT

The question of whether a taxpayer on the cash basis is entitled to a deduction for "interest" under Section 23 (b) of the Internal Revenue Code must be considered in the light of the general principle of tax law that taxpayers on the cash basis, like petitioner here, may take into account, in making their income tax return, only amounts actually received and amounts actually put out in cash or its equivalent. *United States* v. *Mitchell,* 271 U. S. 9; *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269. The word "paid", as used in Section 23 (b) has been given its generally understood and ordinary meaning. Thus, to entitle one to a deduction for interest, a payment must be in cash or its equivalent, and the giving of a note does not constitute such a pay-

ment. *Hart* v. *Commissioner,* 54 F. 2d 848 (C. C. A. 1st); *Keith* v. *Commissioner,* 139 F. 2d 596 (C. C. A. 2d); *Thomason* v. *Commissioner,* 33 B. T. A. 576, appeal dismissed April 29, 1937 (C. C. A. 7th); *Alsberg* v. *Commissioner,* 42 B. T. A. 61; *Hirsch* v. *Commissioner,* 42 B. T. A. 566; *Prime* v. *Commissioner,* 39 B. T. A. 487; *O'Day* v. *Commissioner,* 20 B. T. A. 454; *Solof* v. *Commissioner,* 1 B. T. A. 776. See also *Helvering* v. *Price,* 309 U. S. 409; and *Eckert* v. *Burnet,* 283 U. S. 140, in which taxpayers on a cash basis were not permitted to take deductions for losses in the year when they gave notes with which "to pay" liabilities incurred by them as guarantors.

The Tax Court's conclusion that there was no payment of interest by the petitioner during the taxable year is based on the following findings: (1) As a result of the three loans to petitioners, the bank made $61,193.12 available to him; (2) the bank also credited $7,756.88 to a reserve account known as "interest or discount collected in advance" on these loans, and daily subtracted from such reserve account the amount of interest earned and credited it to the earnings account; and (3) the petitioner gave the bank three promissory notes aggregating $68,950, i. e., $61,193.12 plus $7,756.88. (R. 25.) The petitioner here, having given the bank nothing but its promises to pay in the future, did not pay interest in cash or its equivalent when the loans were made.

But petitioner contends that the term "discounting" means payment in advance, and so in effect argues that we must ignore the facts here because the notes were "discounted." It is, of course, true that in discounting notes, banks treat the interest as paid in advance; but it is equally true that in tax matters we are required to look through formal devices and bookkeeping entries to the real substance of a transaction. When this is done, it is evident that there was in fact no payment here in cash or its equivalent. Instead, the petitioner gave three promissory notes and the bank made some bookkeeping entries including a credit for interest to a special reserve account. Obviously a credit for interest under these circumstances is not proof of actual payment of interest in cash or its equivalent, regardless of how the matter is handled for bookkeeping purposes.

Petitioner is in error in contending that the Tax Court has misapplied *Eckert* v. *Burnet,* 283 U. S. 140. As indicated above, that case involved a loss. Nevertheless, the general principle announced therein is applicable here inasmuch as the Court there held, in substance, that taxpayers on the cash basis who give notes in satisfaction of debts do not "pay" such debts for income tax purposes when notes are given but that payment is made when the debtor parts with cash or its equivalent. The fact that a bank may treat the interest as paid by entering a credit on its books does not establish a cash payment entitling the taxpayer to

a deduction for interest. *Hart* v. *Commissioner,* 54 F. 2d 848, 852 (C. C. A. 1st).

There is no conflict in the authorities on this issue. *Musselman Hub-Brake Co.* v. *Commissioner,* 139 F. 2d 65 (C. C. A. 6th), cited by the petitioner (Pet. 4), involved a taxpayer on the accrual basis. The deductions there sought, consisting of patent royalties and interest, were accrued on the taxpayer's books and the taxpayer's creditor was given demand promissory notes for the amount so accrued. It was held that these notes had a readily realizable value equal to par and the creditor included the amounts as income in his return for the year of receipt. The only question was whether the taxpayer's right to a deduction of such amounts under Sections 23 (a) (1) and (b) of the Revenue Act of 1938, c. 289, 52 Stat. 447, as ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business and as interest accrued during the taxable year, should, although otherwise allowable, be denied because of the provisions of Section 24 (c) of the Revenue Act of 1938 which disallowed deductions by certain classes of taxpayers for incurred expenses and accrued interest if such amounts were not paid within the taxable year, or within two and one-half months after the close thereof, and if by reason of the method of accounting of the person to whom the payment is to be made the amount thereof was not, unless paid, includible in the gross income of such person

for the taxable year in which the taxable year of the taxpayer ends. In that case the Court narrowly construed Section 24 (c), which was designed to prevent tax avoidance, in the light of its legislative history as requiring payment only in such form that the creditor would be required to include the sums in his gross income.

The present case does not involve Section 24 (c) and the taxpayer here was on the cash basis of accounting; he parted with neither cash nor its equivalent but merely gave a promise to pay in the future. In the *Musselman Hub-Brake Co.* case the court's distinction (pp. 68–69) of *Eckert* v. *Burnet*, *Helvering* v. *Price*, and *Mass. Mutual Life Ins. Co.* v. *United States*, *supra*, shows clearly that the court did not consider its decision as conflicting with the general principle that a taxpayer on the cash basis may not deduct amounts which are not paid out in cash but which are merely represented by a promise to pay evidenced by a note.

The case of *Celina Manufacturing Co.* v. *Commissioner*, 142 F. 2d 449 (C. C. A. 6th) cited by the petitioner (Pet. 16), was like the *Musselman Hub-Brake Co.* case, and is likewise distinguishable from the present case.

Furthermore, if the question should be treated as primarily an accounting matter, then the issue is one for the Tax Court, since accounting matters are peculiarly within its province. *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied,

321 U. S. 231. On the issue here, the decisions of the Tax Court show a well established policy to permit deductions for interest only when actually paid in cash or its equivalent. See *Alsberg* v. *Commissioner*, 42 B. T. A. 61; *Prime* v. *Commissioner*, 39 B. T. A. 487; *Hirsch* v. *Commissioner*, 42 B. T. A. 566; *O'Day* v. *Commissioner*, 20 B. T. A. 454; and *Solof* v. *Commissioner*, 1 B. T. A. 776. Also cf. *Chatham & Phenix National Bank* v. *Commissioner*, 1 B. T. A. 460. Petitioner cites *Burgess* v. *Commissioner*, 8 T. C. No. 5, and *Konigsberg* v. *Commissioner*, decided January 22, 1946 (1946 P–H T. C. Memorandum Decisions, par. 46,024), but these cases are distinguishable on their facts and do not show any departure from the Tax Court's other decisions.

## CONCLUSION

The decision below is correct, and there is no conflict in the decisions. The petition should be denied.

Respectfully submitted,

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